The Budget and Spending Task Force

Rep. Rob Woodall, Task Force Chairman

Debt Limit Suspension

- The No Budget, No Pay Act (H.R. 325), which passed the Senate (64-34), was signed into law on Monday. It temporarily suspends the debt limit through May 18th and requires each chamber to pass a budget or face withheld pay. During the suspension period, the Treasury Department is permitted to issue debt to meet necessary obligations.
- While H.R. 325 does not set a numerical limit on the amount of borrowing allowed during the debt ceiling suspension, the Bipartisan Policy Center estimates that this measure could allow up to $450 billion in new borrowing authority.
- There is considerable debate regarding the Treasury Department's authority to unwind (or backfill) already used "extraordinary measures" during the debt ceiling suspension period. Rep. Garrett (R-NJ) and Chairman Scalise (R-LA) sent a letter along with 13 other members to the Treasury Department stating that it was not the intent of the House to permit backfilling of "extraordinary measures" and to request the Treasury Department's position on the matter.

Economic Contraction

- The U.S. Department of Commerce's Bureau of Economic Analysis (BEA) reported last week that Fourth Quarter 2012 GDP contracted by 0.1%. This marks the first time since Second Quarter 2009 that the economy contracted.
- The BEA report indicates that much of the drop in economic output was attributable to a decrease in government spending (-1.33%) and a burn off in business inventories (-1.27%). Much of the decrease in government spending was attributable to a 22 percent quarter-over-quarter decrease in defense spending. This is somewhat misleading, as above average Third Quarter defense spending contributed to this unusually large quarter-over-quarter drop.
- These drops were partially offset by a 13.9% increase in consumer spending (1.52%) and improved business investment and equipment purchases (0.83%). The U.S. economy is still expected to experience growth in 2013.

Sequester Replacement

- Last year, the House twice passed a sequester replacement package (H.R. 5652 and H.R. 6684) that would have replaced FY13 sequester cuts with a variety of savings largely derived from mandatory program reforms. To date, the Senate has not acted on this plan or any other sequester replacement package. Several replacement and reprogramming options are currently under discussion, including:
- Senator Inhofe (R-OK) introduced a measure that would give the Pentagon the authority to transfer funds from one budget function to another in order to ensure some prioritization of sequester cuts. This measure is unanimously supported by Republican members of the Senate Armed Services Committee.

- Many Senate Democrats have indicated their support for a yet undrafted plan that would partially replace sequester cuts with increased tax revenue from the elimination of certain tax provisions (loosely defined “loopholes” for corporations and “wealthy individuals”). The President’s forthcoming “balanced approach” to replacing the sequester will likely include revenue from loophole elimination as well.

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As Contractions Go . . .

Zero growth in the fourth quarter, but don't worry, the Fed is here.

The federal government reported Wednesday that the U.S. economy shrank in the last quarter of 2012, but not to worry. The report is better than it sounds, the stock market is rocking, and in any event the Federal Reserve will take the news as another reason to keep both feet pressed firmly on the monetary accelerator. Bad economy=more Fed cowbell=higher stock prices. Risk on, baby.

The silver-lining crowd is right that the fourth-quarter GDP growth of -0.1% is not as bad as the headline. Most of the decline came from falling business inventories and less government spending, notably a 22.2% decline in defense. The fearless consumer mostly ignored the Washington chatter of fiscal doom and kept spending, while housing is contributing again to growth. Private GDP grew an anemic 1.2%, but at least it grew.

The report's most impressive figure was the surge in personal income, which climbed 7.9%, or $256.2 billion. This was clearly due to companies and investors front-running the January 1 tax increases, via "accelerated and special dividends" that were paid "in anticipation of changes in individual income tax rates," as the Bureau of Economic Analysis put it. BEA estimates that companies paid $39.5 billion in such dividends in the quarter.

So much for the illusion that tax rates don't influence behavior. The income surge may help to explain the buoyant investor sentiment that has carried into the New Year despite the huge tax increase. On the other hand, such income gains won't continue unless the economy resumes far more rapid growth.

The government spending decline deserves a word because the Keynesians are using it to call for more "stimulus." The national income accounts include a Keynesian bias that equates higher government spending with growth, no matter how wasteful the spending. Thus the spending blitz of 2009-2010 gave a fillip to GDP, though not a sustainable one. The Keynesians now decry the very spending cliff they created.

The real story is that the Keynesians promised that the stimulus would kick-start the economy to a higher growth plane. It hasn't. Growth has sputtered in each of the last three years, and for all of 2012 was only 2.2%. That's barely above 1.8% in 2011, which was below 2.4% in 2010. The biggest loser in all of this should be the notion that temporary bursts of government spending can produce durable economic expansions.

By the way, domestic federal spending was up 1.4% in the fourth quarter. The defense spending declines may have been the result of lower war outlays, as well as anticipation of the automatic spending cuts looming from the scheduled March 1 sequester. Republicans say they'll go ahead with those cuts as the only leverage they have in negotiating with Mr. Obama, and they should.

The dangers in defense cuts concern security (see below), not the economy. As for domestic cuts, the White House cry of "austerity" is nonsense, especially after the spending blowout of President Obama's first term. Domestic federal agencies can easily take a 5% spending cut. The cuts will help the economy grow faster by keeping more resources in private hands, which will use them more effectively. Cuts will also help business and investor confidence by finally showing that government can restrain itself—at least a little and however crudely.

Meanwhile, and right on cue for Wall Street, the Fed announced Wednesday after its two-day meeting that it will stick with its bond-buying spectacular. This means buying $40 billion in mortgage-backed securities a month and another $45 billion in longer-term Treasurys. The Fed is on pace to expand its balance sheet by another $1 trillion or so through the end of this year—its fifth in a row of near-zero interest rates and some form of "quantitative easing."

These have been heady days at the Eccles Building, or at least they were before the GDP report. Stock and housing prices have been rising, and investors are walking further out on the risk curve, just as Chairman Ben Bernanke hopes. The Fed has also led a parade of easing around the world, as other central bankers follow to prevent their currencies from rising too much. Even Japan has finally succumbed, raising its inflation target.

Yet the economic paradox of our time is slow growth and lousy job creation despite these monetary exertions. This continues to be the 2% recovery, the slowest in the modern era. The Keynesian explanation is that we're still recovering from the financial panic, though it's worth recalling that in January 2010 the Fed predicted that growth in 2012 would be 3.5% to 4.5%, not 2.2%.

Stanford economist John Taylor offered a different explanation this week, saying on these pages that the Fed's excessive ease may actually be hampering growth thanks to unintended consequences. These include the misallocation of capital as investors chase yield above all, a subsidy for excessive federal spending by disguising the real cost of repaying debt, and the uncertainty of when the Fed will finally have to stop the party.

This debate won't be settled for years, and in any case Mr. Bernanke doesn't listen to Mr. Taylor or us. By now the world knows he'll keep doing what he's been doing until faster growth returns or the markets force him to stop. Risk on, baby.
To the top.

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